Funds passporting schemes in Asia
What do wealth and asset managers need to know?
July 2014
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As recently as 2012, the possibility of an Asian fund passport – a scheme that would allow investment funds to be sold across borders within Asia – was viewed with skepticism by many asset managers. While many in the industry could see the potential benefits of such a scheme, few expected to see one implemented in the foreseeable future.

Move forward to 2014, and asset managers find themselves contemplating not one but three Asian cross-border fund initiatives. The resulting buzz of anticipation is prompting Asian and global firms alike to review their growth strategies for the region.

How much credibility should asset managers place on the current proposals? Should firms respond quickly, or would they do better to wait and see how the schemes develop? This short paper aims to give Asian and international asset managers an introductory briefing on the proposed Asian fund passports, by posing and answering a few fundamental questions. It concludes with our thoughts on the steps firms should be considering if they want to avoid being left behind by the coming changes.
Funds passporting schemes in Asia What do wealth and asset managers need to know?
What does a successful fund passporting scheme look like?

In our view, if fund passporting schemes are to be successful they should ideally have several key attributes. In particular, we highlight the importance of:

- A level playing field for all participants, to offset variation in the sophistication of member states’ asset management markets
- Efficient and transparent licensing – ideally on a mutually recognized or harmonized basis
- Robust governance and oversight of all passport operators
- A range of investment options that offer new opportunities to local investors, while ensuring that products are transparent and well understood
- Efficient and transparent tax arrangements – inter-governmental clarity over the treatment of licensed products is particularly important
- Well-defined distribution mechanisms and codes of conduct
- Clear dispute and compensation procedures for end investors
What are the benefits for member states?

At the macro level, all three proposals have similar goals. They aim to open up Asia’s capital markets, allow a freer flow of capital within the region and improve the integration of member economies. By breaking down national barriers, they aim to increase competition and broaden investor choice. That should have the dual effect of reducing costs for investors and making it easier for them to achieve diversification.

At a national level, participating territories hope that greater cross-border activity will help to raise standards of commercial and regulatory expertise across the region. Less mature investment markets, such as those of mainland China and Southeast Asia, should see the greatest benefits, but offshore investment centers, such as Hong Kong and Singapore, are also hoping to see an improvement in the breadth and depth of their onshore fund industries.

To achieve these goals, the schemes will need to emulate the success of UCITS, the European fund framework that has achieved strong take-up in a number of Asian markets. At its core, that means reassuring investors across Asia that they can invest abroad while enjoying the same standards of performance and protection they would expect in their home market.
What does each scheme involve?

Each of the three proposed schemes has its own distinct features.

The **ASEAN1 framework** aims to allow cross-border distribution of collective investment schemes (CIS) between Singapore, Malaysia and Thailand as part of ASEAN's Capital Markets Integration Plan. Singapore's relatively high level of financial sophistication makes it the obvious hub for the scheme. Although the Memorandum of Understanding between the three countries was only signed in late 2013, an initial framework setting some ground rules for eligible funds — such as a five-year track record and manager Assets under Management (AuM) of at least US$500m — has already been published. A guidance handbook is anticipated, and the scheme is intended to be launched during 2014. Even if this goal proves hard to achieve, there is a clear aspiration for quick implementation. The process of coordination should be comparatively simple, with Singapore likely to provide the blueprint for regulation and product design.

The **Asia Region Funds Passport** (ARFP) has the potential to operate as a truly pan-Asian scheme. Initial signatories Australia, Singapore, South Korea and New Zealand were joined in early 2014 by the Philippines and Thailand. A public consultation is currently in progress, and the pilot group are expected to begin making the necessary adaptations during 2015. The project originates from Australia's desire to expand the reach of its large domestic fund industry, but the scheme's widening membership should help to allay any concerns of imbalance. Singapore's dual role offers the clear potential to learn from experience of the ASEAN framework. However, given the sophisticated level of regulation of several ARFP members, working towards an agreed set of common standards could be time consuming.

In contrast, the proposal for **mutual recognition** of funds between mainland China and Hong Kong should be comparatively simple to implement, even if the structure and timing of the scheme remain opaque. The two markets already have a close political and administrative relationship, and statements from the Securities & Futures Commission suggest the scheme may be launched during 2014. This time frame, and the potential for access to China's domestic fund market, mean that mutual recognition is prompting a rapid response from the industry. A number of international firms are taking steps to establish or strengthen their onshore fund offering in Hong Kong. If the scheme does begin this year — even if on a limited basis — it could provide some useful pointers for the two other regional frameworks.

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1 Association of Southeast Asian Nations
What are the challenges to implementation?

There is no question that the planned cross-border schemes face significant practical obstacles. This is particularly true for the larger ARFP grouping, but all three proposals need to combine a sense of purpose with effective planning and consultation. In the rush to implementation, they must avoid overlooking any hurdles or disincentives that may deter investors.

- The need to overcome the huge variation in tax arrangements across the region — at both fund and investor level — is arguably the most pressing challenge. Some participating markets, most notably Australia, currently take a restrictive approach to offshore funds.
- From a technical standpoint, the greatest obstacle is probably the need for a strong, consistent regulatory framework. None of the schemes will use a single legal or regulatory framework, so participating markets will need to achieve compliance with a common set of qualifying standards.
- Data privacy could also represent a hurdle. Cross-border marketing increases the chance of investor information being transferred between countries, raising the possibility that providers and distributors will need to adhere to a variety of data protection standards.
- In the long run, achieving cultural change may be the greatest challenge. Regulators and asset managers need to educate investors about the risks and benefits of investing across borders, especially in markets, such as South Korea and Malaysia, where local funds are currently dominant.

The probable reality is that it will be some time yet before asset managers from participating countries can sell their funds cross-border as easily as in their home markets. Developing and maintaining an effective passporting regime is an evolving process. It is worth remembering that the UCITS framework has taken 25 years to reach its current position, and that Asia is more diverse than Europe.

Even so, we do not want to exaggerate the obstacles to Asian passporting. Effective coordination does not have to mean a single, rigid infrastructure — something that is, in any case, unlikely to be achievable. The appetite for success suggests that, with a little give and take, passporting will soon become a reality. If mutual recognition between mainland China and Hong Kong is launched within the next few months, we would expect it to provide an additional stimulus to the two other Asian proposals.
What are the opportunities for asset managers?

At a strategic level, the proposed cross-border frameworks offer asset managers access to a more diverse investor base, and a new way to access foreign markets with attractive growth characteristics. At an operating level, passporting should make it quicker for firms to gain cross-border distribution approval and easier to generate economies of scale. Overall, passporting should make it easier for firms to achieve faster levels of growth and, potentially, stronger profitability.

The scale of the potential opportunity is illustrated by Australia. The introduction of compulsory superannuation has created one of Asia’s largest asset management markets, but less than 4% of these funds are invested globally. There is clearly a huge opportunity for foreign firms to sell international products to Australian savers, and for Australian firms to harness their expertise in other Asian markets.

For individual firms, the possible opportunities will depend on their current positions and on the actions they take to improve them. In most cases, an onshore presence in one of the participating markets is likely to be the most important factor. All three schemes implicitly exclude externally domiciled products, even if they have been approved for local sale.

This requirement confers a potential advantage to asset managers with well-established local products. Firms with strong branding and distribution networks will be especially well placed to build a presence across the region. Taking the ASEAN scheme as an example, market-leading Singaporean asset managers are likely to find their existing CIS products – many of which are already marketed in other ASEAN nations via wrappers or feeder funds – easily adaptable for sale in Malaysia and Thailand.

In contrast, international asset managers with a UCITS product range domiciled in Luxembourg or Ireland are likely to find themselves at a comparative disadvantage. If these firms want to take full advantage of Asian cross-border sales, they will either need to set up local funds mirroring their existing products, or to adapt existing onshore funds to meet passporting criteria. We are already seeing these types of responses in Hong Kong as international firms position themselves for access to the fast growing Chinese domestic market.
What uncertainties do asset managers face?

Identifying opportunities is one thing; capitalizing on them is another. Uncertainty over how the passporting schemes will evolve is a significant challenge for asset managers attempting to develop a strategic response to the proposals. We divide these factors into two groups, the practical and the political. The practical uncertainties are likely to be of greater concern to most asset managers. In particular we highlight:

- **Demand**: Without existing market knowledge, many asset managers will struggle to anticipate the commercial feasibility of selling their products in new markets. Entrants will struggle to match the local knowledge of established domestic players. Can existing products be adapted, or will new ones be required? Areas of uncertainty are likely to include investor preferences, risk appetite and the quality of investment advice.

- **Distribution**: Achieving access to investors in unfamiliar markets, particularly in the retail arena, may be the single greatest obstacle for new entrants. Patterns of retail distribution vary across Asia. In South Korea, mainland China and many ASEAN markets, banks and securities houses play a leading role, so achieving exposure and support from these distributors at an affordable cost will be a challenge for foreign firms. In contrast, independent advisors are more influential in mature markets such as Australia and New Zealand. Looking further forward, the development of open architecture across the region may make cross-border distribution easier to achieve. Fund supermarkets are becoming established in South Korea, and online partnerships with retail websites or search engines could generate increasing growth in future.

- **Tax**: Whatever the improvements in regional co-ordination, overcoming tax barriers in markets like Australia and South Korea is likely to remain a challenge for some years. In future, a collective investment vehicle that could accommodate multiple currencies and investment classes across different legal systems might overcome this problem, but for now that remains a faraway prospect.

- **Currency risk**: Asian retail investors are largely accustomed to investing in their home markets. It is unclear how willing investors will be to take on currency risk by investing abroad, especially given the comparatively high volatility of some Asian currencies. This is in contrast to Europe, where many member states’ adoption of the Euro has encouraged cross-border UCITS growth.

Political uncertainty over the evolution of Asian passporting is of less immediate concern to asset managers, but will be important to strategic planning. There is an expectation – whether explicit or assumed – that each scheme will expand in time. Most firms would certainly welcome the inclusion of high growth potential countries, such as Indonesia or Vietnam, in either Asian scheme. However, less developed markets are likely to be sensitive to the potential threat to domestic firms from international competition. That suggests that broadening the schemes will require a gradual approach. Once the ARFP or the ASEAN scheme are up and running it will be easier for new candidates to assess the potential benefits and risks of membership.

Looking even farther ahead, it is possible to imagine some sort of linkage or combination between the competing schemes. As a leading asset management center with its feet in more than one camp, Singapore may be particularly well positioned. In the long term, Hong Kong might also be able to build on its mutual recognition agreement with mainland China to drive some sort of regional coordination. For now, this is pure speculation, but asset managers with regional ambitions in Asia will need to keep an eye on developments.
What should firms be doing now?

Although they are developing rapidly, the current proposals for cross-border fund frameworks contain so many unknowns that it may be tempting for asset managers to ignore them – at least for now. In our view, this would be a mistake. While many asset managers may feel it is too soon to be making major strategic decisions, we believe that any firm with regional aspirations in Asia should at least consider its potential response to the proposals.

The first and most obvious step is for firms to review their current operating model and consider how well placed they are to take advantage of the most attractive opportunities that may flow from Asian passporting. This is likely to involve reviewing product domiciles, legal structures and distribution networks against target markets and investor groups. A second step would be to set up a working group to monitor the proposed initiatives, enabling firms to respond as they develop. A third suggestion is to engage in public and industry consultations, not just to shape the schemes’ evolution but also to improve internal understanding.

Clearly, asset managers will need to develop their own response to the current proposals. Some may decide that the cost of adapting products, distribution and operations to the new regimes is not worthwhile, at least in the early years. But while significant obstacles remain, there is no question that Asian passporting has taken a huge step towards reality in recent months. In our view, asset managers have a responsibility to prepare themselves for the resulting changes to the Asian fund map.
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EYG no. EH0189
CSG/GSC2014/1327651
ED 0115

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